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March 25, 2015

By Electronic Mail
Attn. Patrick Pinschmidt
Deputy Assistant Secretary for the Financial Stability Oversight Council
1500 Pennsylvania Ave., NW, Washington, DC 20220

Re: Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014)

Dear Mr. Pinschmidt,

Markit appreciates the opportunity to comment on the Financial Stability Oversight Council ("FSOC") Notice Seeking Comment on Asset Management Products and Activities ("Notice") published on December 24.[1]

Markit (NASDAQ: MRKT)[2] is a global financial information services company, offering independent data, valuations, risk analytics, and related services across regions, asset classes and financial instruments.[3] Markit products and services are used by numerous market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.[4] Markit therefore shares in common with the Notice the goal of reducing risk, be it systemic or operational, and increasing transparency.

Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the Pittsburgh G20 commitments for OTC derivatives and the design of a new regulatory regime for benchmarks and indices. Over the past years, we have submitted more than 115 comment letters to regulatory authorities around the world and have participated in numerous roundtables.

I. Executive summary

[1] Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014).

[2] Please see www.markit.com for further information.

[3] As of year-end 2013, 37% of Markit's customers were buyside customers, 12% corporate and insurance end-user customers, 20% bank customers, and 5% were government or academic. Approximately 50% of Markit's revenues in 2013 originated in the U.S.

[4] Markit has also advised and developed products for market and prudential regulators, including tools for use for market surveillance, data management, and systemic risk analysis. We also regularly provide relevant regulators with our insights on current market practice, for example, in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily mid-market marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established requirements through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements.

As discussed in further detail below, we believe that liquidity and redemption risk contained in asset management products can be mitigated by providing risk managers[5] or investors of pooled investment vehicles better information about the liquidity risk associated with pool investments so that they can price it more accurately. This could be done through, among other things, disclosures of the "prudent valuation" (accounting for pricing uncertainty) of the fund's investments and the implementation of appropriate liquidity risk management policies and procedures. Such liquidity risk management policies and procedures should be flexible in order to account for different degrees of liquidity risk based on, among other things, the structure of a fund and its asset base.

In addition, we believe that operational risk associated with a concentrated number of vendors that perform key functions for asset managers can be reduced through operational risk policies and procedures and through promoting effective competition among vendors to provide key services to asset managers.

II. Liquidity and Redemptions

Markit believes that the FSOC's liquidity and redemption risk concerns could be mitigated with more rigorous liquidity risk monitoring, risk management, and valuation practices. A comparative review of regulations implemented abroad may be instructive in this context. Below, we provide our answers to questions 2, 8, and 9 from section I of the Notice.

1. Redemption risk is heightened in illiquid instruments

Question 2 from the Liquidity and Redemption section of the Notice asks:

> *To what extent do pooled investment vehicles holding particular asset classes pose greater liquidity and redemption risks than others, particularly during periods of market stress? To what extent does the growth in recent years in assets in pooled investment vehicles dedicated to less liquid asset classes (such as high-yield bonds or leveraged loans) affect any such risks?*

We agree with FSOC's observation that the "incentive to redeem from pooled investment vehicles may be magnified for vehicles invested in less-liquid asset classes."[6] Sellers (and buyers) of illiquid instruments may not be able to transact at the market or competitive price of an instrument

[5] We intend "risk managers" to include the board of directors or others who are or may be responsible for managing a fund's liquidity risk, among other risks. Although the Securities and Exchange Commission ("SEC") requires RIC funds to disclose the board's risk oversight role, the federal securities laws do not impose any specific obligations on RIC directors with respect to oversight of risk management. See Item 17(b)(1) of Form N-1A under the Investment Company Act of 1940 (Investment Company Act) ("disclose the extent of the board's role in the risk oversight of the Fund, such as how the board administers its oversight function and the effect that this has on the board's leadership structure."); see also Item 18.5.(a) of Form N-2 and Item 20(d)(i) of Form N-3. The risk oversight disclosure requirement became effective February 28, 2010. See Proxy Disclosure Enhancements, SEC Release No. IC-29092 (Dec. 16, 2009). Importantly, this disclosure does not impose any risk oversight responsibilities on fund boards. Instead, it merely requires disclosure of the board's role in such oversight. The federal securities laws do, however, impose specific responsibilities on directors, including annual review and approval of the advisory contract, fair valuation of portfolio securities (typically delegated to the adviser), and oversight of the fund's compliance program. See Sections 2(a)(41) and 15(c) of the Investment Company Act and Rule 38a-1 under the Investment Company Act. By fulfilling these regulatory oversight responsibilities, as well as their fiduciary duties, directors also help to mitigate risks that may impact the fund.

[6] Notice at 77,490.

in a timely manner. This is particularly true during a period of market volatility, when the incentive to exit a position in an illiquid instrument is high and in periods where liquidity is particularly sparse (or is expected to become sparse). It follows therefore that increased investment by pooled investment vehicles ("PIVs") in illiquid instruments would increase liquidity and redemption risks, both on the level of the individual fund and system-wide, absent mitigating actions.

2. A PIV's risk managers and its investors should be provided with means to price the liquidity risk of a PIV's asset portfolio

Question 8 from the Liquidity and Redemption section of the Notice asks:

> *To the extent that liquidity and redemption practices in pooled investment vehicles managed by asset managers present any risks to U.S. financial stability (e.g., increased risks of fire sales or other spillovers), how could the risks to financial stability be mitigated?*

We believe that, to answer FSOC's question regarding the risk arising from PIV investment in illiquid or potentially illiquid assets that are subject to redemption risk, one should first ask to what extent such risks are currently mispriced. We believe that FSOC's concerns regarding liquidity risk could be mitigated if a PIV's risk managers and investors had nuanced view portfolio construction and redemption policies in place that enable them to assess liquidity risk against their potential redemption needs.

The Investment Company Act of 1940 ("Investment Company Act") generally requires registered investment companies ("RICs") to use market values to value portfolio securities for which market quotations are readily available.[7] Under the Investment Company Act, when market quotations are not used, the RIC's board of directors is to determine fair valuation to determine prices for portfolio assets.[8] The fair value of an asset is defined by accounting standards as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[9] This is also known as the "exit price" for a position. We understand that the board of directors or investors in RICs may infer the liquidity risk of an asset subject to fair value measurement by the type of input used to determine the asset price.[10]

Risk managers and investors that invest in RIC or non-RIC funds with significant holdings in illiquid instruments are exposed to the risk that existing fair value-related disclosures, e.g., FASB 157 or IFRS 13 Fair Value Measurements,[11] do not adequately provide them with the ability to assess and price the liquidity risk of PIV assets. Specifically, such approach might not be sufficiently granular and could produce misleading results.

[7] Investment Company Act, section 2(a)(41)(B).

[8] Id.

[9] See e.g., IFRS 13.

[10] See id. (Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.).

[11] FASB 157, available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175823288587&blobheader=application/pdf&blobcol=urldata&blobtable=MungoBlobs and IFRS 13, available at http://www.iasplus.com/en/standards/ifrs/ifrs13.

That said, existing accounting disclosures might not be adequate for providing RIC and non-RIC PIV risk managers and investors adequate insight into the liquidity risk of a PIV's portfolio, nor do they appear to be sufficient to address FSOC's concerns as indicated by the issuance of the Notice.

3. <u>Prudent valuation of PIV assets may also assist PIV risk managers and investors price liquidity risk</u>

Question 9 from the Liquidity and Redemption section of the Notice asks:

> *What additional information would help regulators or market participants better assess liquidity and redemption risks associated with various investment vehicles, including information regarding the liquidity profile of an asset class or of a particular type of investment vehicle?*

For Markit's pricing and valuation services, we have always strived to not only provide the highest quality pricing of financial instruments, but also to quantify the degree of uncertainty that is attached to these prices. Over the last several years, the concept of "prudent valuation" has also found its way into several regulatory frameworks, specifically for European banks via CRD IV, the EU Solvency II directive[12], and FCA GENPRU[13] regulations.

Based on our experience, we believe that the calculation and disclosure of a "prudent value" of an illiquid asset portfolio may help regulators and market participants better assess the liquidity and redemption risks of PIV. The concept of "prudent valuation" is related to fair valuation, i.e. the price to sell an asset or paid to transfer a liability in an orderly transaction at the measurement date.[14] In the case of many illiquid assets, the fair value is not easy to determine. Quoting the Bank of England's Rajeev Brar:

> *If a bank has a position valued at 50 and the market is liquid such that the range of plausible valuations is known to be somewhere between 49.9 and 50.1 or if the position is complex and the market is illiquid such that the range of plausible valuations may be somewhere between 20 and 80, then the accounting representation of value is often largely the same. However from a risk and capital adequacy perspective it makes an enormous difference. Whereas accounting standards are looking at best estimates, the regulatory [or prudent valuation] perspective is much more interested in downside risk.*[15]

Experience has shown that the flexibility provided by fair valuation can be abused by banks[16] as well as PIV managers, as recently described in a news article describing an allegation of such

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[12] Solvency II Directive, Nov. 25, 2009, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF

[13] http://fshandbook.info/FS/html/FCA/GENPRU/1/3

[14] See supra at footnote 11 and related discussion.

[15] Prudence Defined, David Wigan, Q3 2013, Markit Magazine, http://content.markitcdn.com/corporate/Company/Files/MagazineEntireIssue?CMSID=c6ed404b81824e4bad6bfd011ee8eea4.

[16] In its 2011 report into the failure of RBS, the FSA used the word "valuation" 114 times in describing the fact that other banks' collateralised debt obligation valuations were "significantly lower" than RBSs'. Failure of RBS, FSA, Dec. 2011, http://www.fsa.gov.uk/pubs/other/rbs.pdf.

opportunistic valuation.[17] Accordingly, the prudent valuation of a fair valued asset includes an adjustment to reflect the degree of uncertainty related to the fair value price and to reflect all the potential costs that might arise once the asset is sold. Under requirements applying to European banks, the prudent valuation adjustment is the amount by which available capital would need to be adjusted if the downside valuations (i.e. least favorable) were used instead of the fair values from a firm's financial statements.[18]

It might be useful to apply this concept of prudent valuation also in an asset management context where the value of illiquid assets is both uncertain and the price of the asset may not otherwise reflect the liquidity risk. Asset managers could account for liquidity risk for illiquid asset valuations by disclosing alongside their fair valuation of an asset, the asset's prudent valuation that accounts for the uncertainty of the price of the asset. The difference between the fair and the prudent value of an asset would then provide an indication of the liquidity risk at the time of measurement, providing risk managers and investors an additional means to gauge and price the liquidity risk of the PIV fund.

4. Alternative Investment Fund Managers Directive's (AIFMD)[19] liquidity risk management requirements may be instructive

In addition to the use of prudent valuation to improve the understanding and pricing of liquidity risk, FSOC might want to consider policies implemented to regulate the asset management industry in Europe. The European AIFMD legislation was implemented in order "to create, for the first time, a comprehensive and secure framework for the supervision and prudential oversight of AIFM in the EU" and, among other things, "[i]ncrease the transparency of AIFM towards investors, supervisors and the employees of the companies in which they invest."[20] Under AIFMD Level 2, Alternative Investment Fund[21] Managers ("AIFMs")[22] are required to, most pertinently:

a. Monitor liquidity risk

Under AIFMD, the AIFM is required to implement and maintain appropriate liquidity measurement arrangements and procedures to assess the quantitative and qualitative risks of its positions and

[17] "Investigators from the SEC's enforcement division are examining whether the $3.6 billion Pimco Total Return ETF bought investments at discounted prices but relied on higher valuations for the investments when the fund calculated the value of its holdings shortly thereafter. Such a maneuver could make it seem as though the ETF had scored quick gains when it was in fact taking advantage of variations in the way some investments are valued in the bond market." Pimco ETF Draws Probe by SEC. Sept. 23, 2014, http://www.wsj.com/articles/pimco-etf-draws-probe-by-sec-1411524226.

[18] See EBA FINAL draft Regulatory Technical Standards, Jan. 23, 2015, at Article 9, https://www.eba.europa.eu/documents/10180/642449/EBA-RTS-2014-06+RTS+on+Prudent+Valuation.pdf.

[19] AIFMD Directive ("AIFMD Level 1"), Jun. 8, 2011, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF, AIFMD Delegated Regulation ("AIFMD Level 2"), Dec. 12, 2013, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF.

[20] Directive on Alternative Investment Fund Managers ('AIFMD'): Frequently Asked Questions, European Commission, http://europa.eu/rapid/press-release_MEMO-10-572_en.htm.

[21] "Alternative Investment Fund" or "AIF" is defined as collective investment undertakings, including investment compartments thereof, which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorization…" AIFMD Level 1, at Article 4(a).

[22] "AIFMD" is defined as "legal persons whose regular business is managing one or more AIFs." Id. at Article 4(b).

of intended investments which have a material impact on the liquidity profile of the portfolio of the AIF's assets to enable their effects on the overall liquidity profile to be appropriately measured. [23] AIFMs are also to continuously monitor the liquidity profile of the AIF's portfolio of assets, having regard to the marginal contribution of individual assets which may have a material impact on liquidity, and the material liabilities and commitments, contingent or otherwise, which the AIF may have in relation to its underlying obligations. In so doing, the AIFM is to take into account the profile of the investor base of the AIF, including the type of investors, the relative size of investments and the redemption terms to which these investments are subject.[24]

AIFMs are also to assess the relative liquidity of the AIF's assets in the market, taking account of the time required for liquidation and the price or value at which those assets can be liquidated, and their sensitivity to other market risks or factors.[25] These assessments are designed to ensure the AIFM has adequate liquidity appropriate to the level of its obligations.

b. Implement liquidity risk management policies and procedures

Liquidity risk management policies and procedures required under AIFMD may be calibrated as appropriate by the AIFM to reflect the AIFM's assets, the amount of liquidity risk to which the AIF is exposed, the scale and complexity of the AIF and the complexity of the process to liquidate or sell assets.[26] Liquidity management systems and procedures can allow AIFMs to apply the tools and arrangements necessary to cope with illiquid assets and related valuation problems in order to respond to redemption requests.[27] Such tools and arrangements may include, where allowed under national law, gates, partial redemptions, temporary borrowings, notice periods, pools of liquid assets,[28] risk limits regarding the liquidity or illiquidity of the AIF,[29] and stress tests[30] enable liquidity risk of the AIF to be assessed and monitored under normal and exceptional liquidity conditions including through the use of regularly conducted stress tests.[31]

c. Conduct due diligence when determine to invest in illiquid asset investments

Under Article 19 of AIFMD, AIFMs seeking to invest in illiquid assets ("assets of limited liquidity") must conduct due diligence and keep records of such due diligence for at least five years.[32]

d. Implement conflicts of interest policies

[23] AIFMD Level 2, at Article 47.1(d).

[24] Id., at Article 47.1(b).

[25] Id., at Article 47.1(a).

[26] Id. at (58).

[27] Id.

[28] Id.

[29] Id. at (61).

[30] Id. at (62).

[31] Id. at Article 40.3(b).

[32] Id. at Article 19.

Under Article 43 of AIFMD, AIFs are to establish safeguards in areas where they are exposed to conflicts of interest. These include a requirement that the risk management function (including management of operational risk) are reaching decisions “arrived at independently.”[33]

Under Article 32 of AIFMD, open-ended AIFs are to identify, manage and monitor conflicts of interest arising between investors wishing to redeem their investments and investors wishing to maintain their investments in the AIF, and any conflicts between the AIFM's incentive to invest in illiquid assets and the AIF's redemption policy.[34]

e. Implement disclosure requirements

Under Article 108 of AIFMD, AIFMs must make available to investors before they invest in an AIFM, a definition of the AIF's liquidity risk management policies, including redemption rights.[35] Periodic disclosures are required related to the percentage of assets which are subject to special arrangements arising from their illiquid nature[36] and when new arrangements are entered into to manage the liquidity of the AIF.[37]

5. Liquidity risk management policies should provide risk managers some degree of flexibility in assessing appropriate risk management policy

While we think increased rigor and standardization around the assessment of liquidity risk would help mitigate FSOC's concerns regarding redemptions in stressed market circumstances, we note that any liquidity risk management requirement for asset managers should be flexible to account for different PIV structures and asset portfolios. For example, a closed-ended fund, because it has a finite asset base, is not subject to the same kind of redemption risk cited by FSOC compared to an open-ended fund.

III. Operational Risk

We believe that FSOC's concerns relating to operational risk can be mitigated through operational risk management procedures. Our comments, detailed below, relate generally to means by which asset managers can reduce operational risk and also comment on two questions from the Notice relating to operational risk associated with the use of vendors. The questions relating to vendors discuss the operational risks relating to reliance on one or a few vendors that provide “key functions,” i.e. asset pricing and valuation, portfolio risk modeling platforms, order management and trade processing, trading, securities lending agent services, and custodial services. As Markit provides several of these functions for its asset manager customers, these points bear directly on us.

Question 5 of section III of the Notice relating to operational risks asks:

> *To what extent do asset managers rely on affiliated or unaffiliated service providers in a concentrated or exclusive manner for any key functions (e.g., asset pricing and valuation,*

[33] Id. at Article 43.1(d).

[34] Id. at Article 32.

[35] Id. at Article 108.3..

[36] Id. at Article 108.2.

[37] Id. at Article 108.3.

portfolio risk modeling platforms, order management and trade processing, trading, securities lending agent services, and custodial services)? What would be the impact if one or more service providers ceased provision of the service, whether due to financial or operational reasons, or provide the service in a seriously flawed manner? To what extent do potential risks depend upon the type of service provided, whether the provider is affiliated with the asset manager, or whether the service provider is non-U.S. based? What due diligence do firms perform on systems used for asset pricing and valuation and portfolio risk management?

Question 7 asks:

What are best practices employed by asset managers to assess and mitigate the operational risks associated with asset management activities performed by service providers, whether affiliated with the asset manager or not, and how common are these practices across the industry? What agreements or other legal assurances are in place to ensure the continued provision of services? What are asset managers' contingency plans to deal with potential failures of service providers, and how might these plans be impacted by market stress?

1. Operational risk management policies and procedures can mitigate operational risk concerns generally

Generally speaking, asset managers may reduce operational risk through policies and procedures designed to monitor, assess, document, and address operational risks. Such operational risk management policies and procedures should be expected of any sophisticated business – or asset manager. We note that under AIFMD, asset managers are to establish risk management policies and procedures designed specifically to reduce operational risk.[38]

2. Operational risk management policies and procedures can mitigate operational risk concerns relating to vendors

The same principle discussed immediately above applies equally to vendors. As a matter of prudent risk management, vendors should have in place policies and procedures designed to monitor, assess, document, and address operational risks. Operational risks that affect a vendor's customers also affect the competitiveness of a vendor.

While we believe market discipline is generally adequate to ensure that vendors adequately manage the operational risks that can adversely impact their customers, we would not be opposed to more formal operational risk requirements on vendors that perform the key functions discussed in the Notice, i.e. asset pricing and valuation, portfolio risk modelling platforms, order management and trade processing, trading, securities lending agent services, and custodial services.

If regulators seek to formalize these operational risk management standards for vendors that perform key functions, they should be cognizant of similar requirements relating to vendors that have been implemented or discussed at both the U.S. (e.g., Office of the Comptroller of the Currency guidance[39]) and international[40] levels.[41] In any such formalized rulemaking or guidance

[38] See Id., Articles 13, 40, 41, 44, and 45.

[39] OCC Bulletin 2013-29, http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html, Oct. 30, 2013.

relating to the use of vendors by asset managers, we urge regulators to harmonize with these existing standards in order to reduce duplicative compliance costs.

3. Regulators should encourage competition among key service providers in order to reduce the operational risk associated with reliance on one or a few such service providers

While market discipline and the prospect of losing customers in the event of routine or severe operational risk events may be effective when there are many vendors for an asset manager to use, this is not the case where a single vendor provides a key function. Accordingly, concerns relating to the operational risks associated with reliance on a sole or a "concentrated" number of service providers (as discussed by questions 5 and 7 of section III of the Notice) could be mitigated through increased competition among service providers.

Regulators could encourage such competition by, among other things, requiring that service providers providing key functions provide their customers the ability to purchase and utilize such services separately and independently. The importance of empowering customers to purchase such services separately is particularly important when a vendor has market power in one of more of these key functions or has market power in the provision of other financial services, e.g., execution or clearing or data repository services, particularly those that can create market power.[42] A competitive market for vendor services would ensure that asset managers (and others) can select the vendor most qualified, effective, cost-efficient, and operationally sound for each particular vendor service function.

In a market for key vendor services that is competitive, the likelihood of conflicts of interest is reduced as well. When vendors have to compete separately for separate key functions and other financial services, their incentive to provide opportunistic services is reduced, thereby reducing the chance their services are provided in a manner that could create operational risk for a customer.

4. Regulators should encourage the use of independent vendors

We note that operational risks and conflicts of interest are also of concern when an asset manager relies solely on an affiliated vendor. We think such concerns would be mitigated if asset

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[40] Assessment methodology for the oversight expectations applicable to critical service providers, Committee on Payment and Settlement Systems Board of the International Organization of Securities Commissions, Dec. 2013, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD432.pdf?n=59100.

[41] For a collection of materials and links relating to standards governing the use of vendors from different sources, see Third Party Risk Management, http://www.sifma.org/issues/operations-and-technology/cybersecurity/third-party-risk-management/.

[42] We note that the the Securities and Exchange Commission ("SEC") recently promulgated Regulation SBSDR contains guidance that specifies when an securities-based swap data repository ("SDR") acts in a manner that constrains competition or is indicative of a conflict of interest:

a. When the SDR charges unfair or unreasonable fees. In evaluating the fairness and reasonableness of fees that an SDR charges for bundled and unbundled services, the SEC stated they will take into consideration, among other things, the SDR's cost of making those services available on a bundled or unbundled basis, as the case may be, and a market participant's proportional use of the SDR's services.
b. When the SDR requires that its services, regulatory and non-regulatory, be purchased on a bundled basis.
c. When the SDR misuses or misappropriates data reported to the SDR for financial gain.

managers utilize the services of an independent vendor when appropriate. For example, in the valuation of assets, the role of a neutral, independent external valuation expert is important, particularly where the asset manager or its affiliated service provider could have an economic incentive for use of an opportunistic valuation. Such concerns could also be addressed through conflicts of interest policies and procedures.[43] The use of an independent vendor also provides for operational redundancy and a second or independent source of data and information that can reduce operational risk.

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Markit appreciates the opportunity to comment on the Commission's request for comment. We would be happy to elaborate or further discuss any of the points addressed above. In the event you may have any questions, please do not hesitate to contact the undersigned or Salman Banaei at salman.banaei@markit.com.

Yours sincerely,

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[43] Under Article 43 of AIFMD, AIFs are to establish safeguards against conflicts of interest. These include a requirement that the risk management function (including management of operational risk) are reaching decisions "arrived at independently." AIFMD Level 2, Article 43.1(d).